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## Planning Alimony and Marital Settlements

Alimony payments that meet tax law tests of this chapter are deductible if you pay them, and taxable if you receive them. Payments are not deductible by the payer unless taxable to the recipient.

You claim a deduction for deductible alimony that you pay on Line 29 of Form 1040. You deduct the payments even if you claim the standard deduction rather than itemizing deductions. You must enter the Social Security number of your ex-spouse. Otherwise, your deduction may be disallowed and you may have to pay a \$50 penalty. If you pay deductible alimony to more than one ex-spouse, enter the Social Security number of one of them and provide similar information for the others on a separate statement attached to your return.

If you receive taxable alimony, report the payments on Line 11 of Form 1040. You must give your ex-spouse your Social Security number and could be subject to a \$50 penalty if you fail to do so.

### **Tax Rules for Alimony Payments**

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*See ¶*

## ¶37.1 Planning Alimony Agreements

You can arrange beforehand the way in which the costs of a divorce are to be borne. You may specifically state in the decree or agreement that the alimony is neither taxable to the payee-spouse (under IRC section 71), nor deductible by the payer-spouse (under IRC section 215). Such a statement effectively disqualifies payments that otherwise would be taxable to the payee-spouse and deductible by the payer-spouse. A copy of the agreement that contains the statement must be attached to the tax return of the payee-spouse for each year the statement is applicable.

The first step in planning the after-tax consequences of alimony is convincing a couple that they may have a common financial interest; the second is projecting future tax consequences.

For example, assume that the husband is to make payments to the wife. If tax planning is approached from the viewpoint of each spouse separately, the tax deduction is an advantage for the husband; tax-free income is an advantage for the wife. However, both advantages cannot be achieved, and the couple must face the reality of the tax law, which allows the husband to deduct payments only if they are taxed as alimony to the wife. They must compromise by setting amounts and tax consequences that balance their interests.

One approach is to view both spouses as a single economic tax unit. If this is done and the husband will be in a higher tax bracket during the payout period than the wife, an agreement should generally provide for taxable and deductible alimony. The tax savings provided by the deduction can conserve more of the husband's assets while providing funds required by the wife. The final amount of alimony to be paid depends on the spouses' tax brackets. Where tax brackets do not differ, there may be no advantage in making an agreement for taxable and deductible alimony when viewing the two parties as a unit.

If you agree that one spouse is to pay deductible alimony and the other spouse is to report the alimony as income, these rules must be met:

- The alimony must be paid under the decree of divorce or legal separation agreement or decree of support; *see* ¶37.2.
- The agreement must provide for cash payments; *see* ¶37.3. There is no minimum payout period for annual alimony payments of \$15,000 or less. One payment of \$15,000 can qualify as deductible and taxable alimony. There is also no minimum payout period for annual alimony payments exceeding \$15,000. However, recapture of alimony deductions claimed in the first or second year may occur where annual payments of over \$15,000 are scheduled and paid, but in the second or third year a reduced payment is made. To avoid recapture of deductions for payments over \$15,000, carefully plan schedules of declining payments within the rules of ¶37.7.
- In providing for the support of children, a specific allocation to their support or the setting of certain contingencies disqualifies payments as deductible and alimony as taxable; *see* ¶37.5.

- Divorced and legally separated parties may not live in the same household. If they live in the same household, alimony payments are not deductible or taxable. However, there are these exceptions: A spouse who makes payments while preparing to leave the common residence may deduct payments made within one month before the departure. Also, where you are separated under a written agreement, but not legally separated under a decree of divorce or separate maintenance, you may deduct alimony payments even if you both are members of the same household.
- The payer spouse's liability to pay alimony must end on the death of the payee spouse. The alimony agreement does not have to state expressly that payments end on death if liability ends under state law; *see* ¶37.4.



### Reporting Alimony

If you paid alimony in 1996 meeting the deductible tests, claim your deduction on Line 29 of Form 1040, and enter the recipient's Social Security number. If you receive qualifying alimony payments, report them on Line 11 of Form 1040.

## ¶37.2 Decree or Agreement Required

Alimony, to be deductible and taxable, must be required by one of the following: (1) a decree of divorce or legal separation; (2) a written separation agreement; or (3) a decree of support. This rule applies to both pre-1985 and post-1984 decrees and agreements. Voluntary payments are not deductible.

**Divorced or legally separated.** The obligation to pay alimony must be imposed by the decree of divorce or separate maintenance or a written agreement incident to the divorce or separation.

Alimony paid under a Mexican divorce decree qualifies. Payments under a Mexican or state decree declared invalid by another jurisdiction do not qualify according to the IRS. Two appeals courts have rejected the IRS position.

Support payments ordered by a court in a wife's home state qualify as alimony, even though not provided for by an *ex parte* divorce decree obtained by the husband in another state. Similarly, payments qualified when a state court increased support originally ordered before the husband obtained an uncontested Mexican divorce.

Payments made under a separation approved by a Roman Catholic ecclesiastical board do not qualify.

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## Key to Alimony and Marital Settlement Issues

Item—	Comments—
<b>Alimony</b>	<p>The same rules determine whether alimony is deductible and taxable. For example, if a husband makes deductible alimony payments to his ex-wife, the payments are taxable to her. He may not deduct payments that are not taxable to her.</p> <p>If you are currently planning an alimony agreement, consider the tax consequences to both spouses. As current tax rates may be as high as 39.6% for one spouse and as low as 15% for the other, there may be a substantial tax savings to the couple, when considered as an economic unit, in negotiating an agreement that qualifies the payments as deductible alimony; see ¶37.1.</p> <p><i>Note:</i> Prior tax rules that apply to pre-1985 agreements are not discussed in this chapter. If you have a problem involving a payment of alimony under a pre-1985 agreement, refer to a past issue of <i>Your Income Tax</i> or to IRS Publication 504.</p>
<b>Child support agreements</b>	A payment fixed as payable for the support of your child may not qualify as deductible or taxable alimony; see ¶37.5.
<b>Property settlements</b>	<p>Transfers of property between a couple that are incident to a divorce are treated as a tax-free exchange. There is no recognition of gain or loss.</p> <p>Future tax consequences should be considered by the spouse receiving appreciated property. When the property is sold, that spouse will be taxed on the appreciation. If this is so, that spouse may want to bargain for larger alimony payments or additional property to compensate for the projected future tax; see ¶6.6.</p>
<b>Alimony to nonresident alien</b>	If you pay alimony payments to a nonresident alien, and you are a U.S. citizen or resident, you must withhold 30% (or a lower rate as set by treaty) on each payment for income tax purposes. See IRS Publications 504 and 515 for more information.
<b>Exemptions for children</b>	Exemptions for children of a divorced couple are governed by the rules explained at ¶22.11. Further, where a spouse is in the income range requiring the phaseout or disallowance of personal exemptions (¶22.15), there may be no advantage in providing the exemption to that spouse. The exemption should be given to the spouse who may claim a full deduction for the exemption.
<b>Annuity or endowment policy</b>	Funds for payments of alimony may be provided through the purchase of an annuity or endowment policy. You may not deduct payments made under the policies assigned or purchased for your spouse. For example, to meet an alimony obligation of \$500 a month, you buy your spouse a commercial annuity contract. The full \$500 a month received by him or her is taxable. You may not deduct these payments.
<b>Trust to pay alimony</b>	<p>To meet your alimony obligations, you may transfer income-producing property to a trust that is to pay the income to your spouse. You may not deduct payments made by the trust. You are not taxable on the income earned by the trust, even though it meets your alimony obligations. This tax treatment is the equivalent of receiving a tax deduction for paying alimony.</p> <p>If you receive alimony from a trust, ask the trustee how to report such income. Tax treatment may depend on whether the trust was created before 1985 or after 1984. If the trust was set up after 1984, as a beneficiary you generally report trust income under the general trust reporting rules in Chapter 11. These general trust rules may not apply to certain alimony trusts created before 1985 that were subject to the prior alimony rules. Distributions from such trusts may be treated as taxable alimony regardless of whether the distributions are from income or principal. In any event, the trustee should provide you with the necessary tax information.</p>
<b>Retirement plans</b>	A state court can allocate your interest in a qualified retirement plan to a former spouse in a qualified domestic relations order. The benefits are taxed to your former spouse when they are paid to her or him. Benefits paid to another beneficiary, such as a child, are taxable to you; see ¶7.12.
<b>Remarriage's effect on pre-1985 agreement</b>	The tax deduction allowed for alimony payments made under a pre-1985 decree or agreement hinges on the obligation to support. Once the spouse receiving alimony remarries, the obligation to support generally ends under state law. In these states, any payment after remarriage is not considered alimony and is not deductible. For example, payments to a former wife made after remarriage are considered tax-free gifts if the former husband knows of the remarriage and that he is no longer obligated to pay. If she does not inform him of her remarriage, his payments are taxable to her but are not deductible by him.
<b>Voluntary payments in excess of required alimony</b>	Voluntary payments in excess of required alimony are not deductible or taxable as alimony. Amending the decrees retroactively to cover an increase does not qualify the increase as deductible and taxable alimony. The increase has to be approved by the court before the increased payments are made.

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When a decree of divorce or separate maintenance fails to mention alimony, payments qualify as long as they are made under a written agreement considered “incident to” the decree.

Payments made under an agreement *amended* after a divorce or legal separation may also qualify, if the amendment is considered “incident” to the divorce or separation. For example, the IRS agrees that a *written* amendment changing the amount of alimony payments is incident to the divorce where the legal obligation to support under the original agreement survived the divorce. However, payments under an amended agreement did not qualify where the original agreement settled all rights between the husband and wife and made no provision for future support. The legal obligation to support the wife did not survive the divorce and could not be revived by the new agreement.

**Annulments.** Payments made under an annulment decree qualify as deductible (and taxable) alimony.

**Where a couple is separated and living apart, alimony is deductible by the payer-spouse and taxable to the payee-spouse provided it is paid under either a written separation agreement or decree of support.**

**A decree of support.** Any court decree or order requiring support payments qualifies, including alimony *pendente lite* (temporary alimony while the action is pending) and an interlocutory (not final) divorce decree.

In certain community property states, payments under a decree of alimony *pendente lite* which do not exceed the wife’s interest in community income are neither deductible by the husband nor taxable to the wife; payments exceeding the wife’s interest are taxable to her and deductible by the husband.

## ¶37.3 Cash Payments Required

Only payments of cash, checks, and money orders payable on demand qualify as taxable and deductible alimony.

Providing services or transferring or providing property does not qualify. For example, you may not deduct as alimony your note, the assignment of a third party note, or an annuity contract.

Your cash payment to a third party for a spouse qualifies if made under the terms of a divorce decree or separation instrument. For example, you pay the rent, mortgage, tax, medical expenses, or tuition liabilities of your former spouse. The payments qualify if made under the terms of the divorce or separation instrument. If taxable as alimony, your former spouse may deduct your payment of real estate taxes, mortgage interest, or medical expenses if he or she claims itemized deductions. You may not deduct payments to maintain property owned by you but used by your spouse. For example, you pay the mortgage expenses, real estate taxes, and insurance premiums for a house which you own and in which your former spouse lives. You may not deduct those payments as alimony even if required by a decree or agreement.

Premiums paid for term or whole life insurance on your life made under a divorce or separation instrument qualify as deductible alimony to the extent your former spouse owns the policy.



### Payments to a Third Party

Cash payments to a third party may be deducted as alimony if they are under the terms of a divorce decree or separation instrument, as just discussed. You may also deduct as alimony payments made to a third party at the written request of the payee spouse. For example, your former wife asks you to make a cash donation to a charitable organization instead of paying alimony installments to her. Her request must be in writing and state that both she and you intend the payment to be treated as alimony. You must receive the written request before you file your return for the taxable year in which the payment was made. Your former wife may deduct the payment as a charitable contribution if she claims itemized deductions.

## ¶37.4 Payments Must Stop at Death

Payments must stop on the death of the payee-spouse. If not, none of the payments, whether made before or after the payee’s death, qualify as taxable or deductible alimony.

The divorce decree or separation agreement does not have to specifically state that payments end at death, if under state law the liability to pay ends on the death of the payee-spouse.

To the extent that one or more payments are to begin, increase in amount, or accelerate after the death of the payee-spouse, such payments may be treated as a substitute for the continuation of payments terminating on the death of the payee-spouse.

### EXAMPLES

1. Under the terms of a divorce decree, Smith is obligated to make annual alimony payments of \$30,000, terminating on the earlier of the end of six years or the death of Mrs. Smith. She also is to keep custody of their two minor children. The decree also provides that if on her death the children are still minors, Jones is to pay annually \$10,000 to a trust each year. The trust income and corpus are to be used for the children until the youngest child reaches the age of majority. Under these facts, Smith’s possible liability to make annual \$10,000 payments to the trust is treated as a substitute for \$10,000 of the \$30,000 annual payments. \$10,000 of each of the \$30,000 annual payments does not qualify as alimony.
2. Same facts as in Example 1, but the alimony is to end on the earlier of the expiration of 15 years and the death of Mrs. Smith. Further, if Mrs. Smith dies before the end of the 15-year period, Smith will pay her estate the difference between the

total amount that he would have paid had she survived and the amount actually paid. For example, if she dies at the end of the tenth year, he will pay her estate \$150,000 (\$450,000 – \$300,000). Under these facts, his liability to make a lump-sum payment to the estate is a substitute for the full amount of each of the annual \$30,000 payments. Accordingly, none of the annual \$30,000 payments qualifies as alimony.

## ¶37.5 Child Support Payments Are Not Alimony

A payment is fixed as payable for child support if the divorce or separation instrument specifically fixes an amount payable for support. That amount is not deductible or taxable as alimony.

Even if there is not a specific allocation to child support, a payment will be treated as payable for child support if it is to be reduced on the happening of a contingency relating to the child, such as: the child reaches a specific age or income level, or the child leaves school, marries, leaves the parent's household, or begins to work.



### Alimony Reductions Tied to Child's Age

If a reduction in your payments is not specifically tied to your child's reaching majority age but the scheduled date for the reduction is within six months before or after your child reaches age 18 or 21 (or other age of majority under local law), the IRS holds that the reduction is tied to the child's age. The reduction amount will be treated as child support unless you can prove that the reduction is for some other purpose. The IRS makes the same presumption if you have more than one child and your alimony payments are to be reduced at least twice and each reduction is within one year of a different child's reaching a particular age between ages 18 and 24; see the Example below.

#### EXAMPLE

On July 1, 1991, a couple is divorced when their children, John (born July 15, 1976) and Jane (born September 23, 1978), are ages 14 and 12. Under the divorce decree, the husband is to make monthly alimony payments of \$2,000. The monthly payments are to be reduced to \$1,500 on January 1, 1997, and to \$1,000 on January 1, 2001. On January 1, 1997, the date of the first reduction, John will be 20 years, 5 months, and 17 days old. On January 1, 2001, the date of the second reduction, Jane will be 22 years, 3 months, and 9 days old. As each reduction is to occur not more than one year before or after each child reaches the age of 21 years and four months, the IRS will presume that the deductions are associated with the happening of a contingency relating to the children. The two reductions total \$1,000 per month and are treated as the amount fixed for the support of the children. Thus, \$1,000 of the \$2,000 monthly payment does not qualify as alimony. To avoid this result, the husband must prove that the reductions were not related to the support of the children.

If both alimony and child support are specified and a payment is less than the total of the two amounts, then the payment is first allocated to child support.

**Tax refund diversion for delinquent child support.** The IRS can give your tax refund to a state which is paying support to your child if you fail to make support payments. For past-due support of a child in a family receiving AFDC welfare payments, the IRS has the authority to make the diversion where the delinquency is \$150 or more and is overdue for at least three months. The IRS will not notify you of the diversion until it is made to the state. However, a federal court has held that a state must provide notice to all those whose refunds may be intercepted, specifying possible defenses and how to challenge the diversion before it is made; judicial review of the state's administrative decision must also be available.

For support of non-AFDC families, the IRS may divert your refund if you owe child support of \$500 or more; the state agency must provide prior notice of the proposed offset and procedures for contesting it.

## Minimum Payments and Recapture of Alimony

### ¶37.6 No Minimum Payment Period for Alimony

There is no minimum payment period, but a recapture rule applies where payments fall by more than \$15,000 within the first three years; see ¶37.7.

### ¶37.7 3rd Year Recapture If Alimony Drops \$15,000 or More

The recapture rules are designed to prevent the so-called "front loading" of property settlement payments disguised as alimony. However, the rules apply even where no property settlement was intended if you come within its terms. Here are the rules: Deductible payments made in the first year or second year may be recaptured (that is, reported as income) in the third year where payments within the first three years decline by more than \$15,000. The three years are called "post-separation years." The first post-separation year is the first calendar year in which you pay alimony under a decree of divorce or separation agreement. The period does not begin with the year of the decree or agreement if no payments are made. Recapture does not apply to temporary support payments made before the final decree or agreement. The second and third post-separation years are the next two calendar years after the first post-separation year whether or not payments are made during those years.



Payments made in the second post-separation year are recaptured if the payments exceed the payments made in the third post-separation year by more than \$15,000. Payments made in the first post-separation year are recaptured if they exceed the average payments made in the second post-separation year and the third post-separation year by more than \$15,000. The following Examples illustrate how to make these computations.

**When recapture does not apply.** Recapture is not triggered if payments in both the first and second post-separation years do not exceed \$15,000. Recapture also does not apply to:

- Payments made under a continuing liability to pay for at least three years a fixed part of your income from a business or property or from a job or self-employed business or profession, or
- Payments that end because of your death or the death of your former spouse or the remarriage of your former spouse at any time before the end of the third post-separation year.

**Reporting recapture on your return.** The payer-spouse reports the recaptured amount as income in the third year and the payee-spouse claims a deduction for the same amount. The payer reports the recaptured amount on Form 1040, Line 11 (alimony received); cross out “received” and write “recapture” along with the payee-spouse’s Social Security number.

The payee-spouse deducts the recaptured amount on Form 1040, Line 29 (alimony paid). He or she crosses out the word “paid” and writes “recapture,” and also enters on that line the payer-spouse’s Social Security number.

#### Steps of recapture:

- Step 1.** Recapture for the second-year payment is computed first. This is the excess, if any, of the second-year payment over the third-year payment, *minus* \$15,000.
- Step 2.** Recapture for the first-year payment is computed next. There is recapture if the first-year payment exceeds by more than \$15,000 the average payment made in the second and third years. In figuring the average payment, reduce the second-year payment by any recapture amount for the second year figured under Step 1.

### EXAMPLES

1. In 1994, Jones obtains a divorce and pays deductible alimony of \$50,000. His wife reports \$50,000 as income. In 1995 and 1996, he makes no payments. On his 1996 return, \$35,000 of the first year 1994 deduction is recaptured (\$50,000 – \$15,000) and reported as income by Jones. His ex-spouse deducts \$35,000.

2. In 1994, Smith makes his first alimony payment of \$50,000; in 1995 he pays \$20,000 and, in 1996, he pays nothing. On his 1996 return, \$32,500 is recaptured as follows:

Recapture of second-year payment:			
Payment in 2nd year			\$20,000
Less: 3rd-year payment	\$0		
Less: allowance	15,000		15,000
Recapture for second year			\$ 5,000
Recapture of first-year payment:			
Average calculation:			
Payment over the 2nd and 3rd years	\$20,000		
Less: recapture in the 2nd year	\$ 5,000		
	15,000		
Average (\$15,000 ÷ 2)	\$ 7,500		
Payment in first year			\$50,000
Less: Average	\$ 7,500		
Less: Allowance	15,000		22,500
Recapture for first year			\$27,500
Total recaptured in 1996:			
For second year			\$ 5,000
For first year			\$27,500
Total:			\$32,500

## ¶37.8 Legal Fees of Marital Settlements

**If you are receiving taxed alimony,** you may deduct part of your legal fees. Ask your attorney to divide his or her fees into charges for arranging: (1) the divorce or separation; and (2) details of the alimony payments.

You may deduct the legal fees allocated to (2), but you may not deduct the fee attributed to the divorce or separation negotiation. The deduction is subject to the 2% adjusted gross income (AGI) floor on miscellaneous itemized deductions (*see* Chapter 19). If the alimony is not taxed to you, you may not deduct any part of the fee. However, part of a fee allocated to a property settlement may be added to the basis of the property.

**If you are paying deductible alimony,** you may not deduct legal fees paid for arranging a divorce or for resisting your spouse’s demands for alimony. Furthermore, you may not deduct legal fees incurred in resisting your spouse’s claims to income-producing

property the loss of which would affect your earnings. However, these rules do not bar you from deducting that part of your legal fee that is identified as being paid for tax advice. The following types of proof may support a deduction:

- The fee is charged by a firm that limits its practice to state and federal matters and is engaged to advise on the consequences of a property settlement involving the transfer of property in exchange for other property and the release of the other spouse's marital rights in the property.
- The fee is charged by a firm engaged in general practice which assigns tax problems, such as the tax consequences of creating an

alimony trust, to its special tax department. On the bill, an allocation is made for tax advice based on time, complexity of the case, and the amount of tax involved.

- An attorney handles the divorce for a fixed fee and also gives advice on the right to claim exemptions for the children following the divorce. The bill allocates part of the fee to the tax advice, based on time, and fees customarily charged in the locality for similar services.

You may not deduct your payment of your spouse's legal fees as a miscellaneous itemized deduction, even if the fees are only for tax advice. However, the fees may be deductible as alimony under the rules of ¶37.3 for payments to third parties.